

Extension of Tax Relief Brings Transfer Tax Certainty – at Least Until 2013

While 2010 was a year of both uncertainty and opportunity for estate planning, 2011 and 2012 will be years of great opportunity. The *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010*, signed into law by President Obama on December 17, 2010, makes substantial albeit temporary changes to the federal gift, estate and generation skipping transfer (GST) taxes. The new law was enacted just days before the 10-year phase out and repeal of the estate and GST tax was set to expire and we would have returned to a \$1,000,000 estate tax exemption and 55% maximum rate. The highlights of the new law include an exemption of \$5,000,000 and maximum rate of 35% for all three taxes. Of particular significance, beginning in 2011 the lifetime gift tax exemption will increase from \$1,000,000 to \$5,000,000, so a married couple will be able to give away a cumulative total of \$10,000,000 free of gift tax. The law also permits a surviving spouse to utilize the unused estate tax exemption of a predeceased spouse. These changes will be in effect for just two years, but the increase in lifetime exemption will permit people who are in a position to make substantial gifts during this period to take full advantage of that exemption right away.

Special Rules for 2010

The new law clarifies the rules applicable to gifts made and decedents dying during 2010.

- For 2010 gifts, the law remains unchanged—the lifetime exemption is \$1,000,000 and the tax rate on the excess over that amount is 35%.
- The estate tax has been restored retroactively for 2010 with a \$5,000,000 exemption, a 35% rate and a full basis step-up, although estates of decedents dying during the year will have the opportunity to elect out of the estate tax and instead receive only a limited basis step-up under the rules that had been in effect prior to the new legislation.
- The GST tax also has been restored for 2010, but the tax rate for generation-skipping transfers during the year is zero. The GST exemption has been increased to \$5,000,000 and may be allocated to 2010 gifts and transfers at death. Restoration of the tax for 2010 clarifies that GST exemption may be allocated to 2010 transfers, and that the automatic allocation rules will apply for the year. It also clarifies that a gift in trust for a grandchild in 2010 will not give rise to GST tax when distributions are made to the grandchild in later years even if no GST exemption is allocated to the gift.
- The time for filing 2010 estate tax returns, making tax payments and making qualified disclaimers has been extended for 9 months following enactment.

New Rules for 2011 and 2012

The biggest benefits come in 2011 and 2012—

- The new cumulative exemption of \$5,000,000 will apply to the gift tax as well as the estate and GST taxes. Beginning in 2012, the exemption amounts will be indexed for inflation.
- The rate for gift, estate and GST taxes will be 35%.
- For a married couple, the unused estate tax exemption of the first spouse to die will be available to the surviving spouse for gift and estate tax purposes (but not GST tax purposes). This is referred to as “portability” of exemption.
 - Portability is limited to the unused exemption of the “last” predeceasing spouse.
 - The deceased spouse’s unused exemption is not indexed for inflation.
 - Use of a deceased spouse’s unused exemption requires filing an estate tax return for the predeceasing spouse and an election on that return. The statute of limitations on that return will remain open until after the surviving spouse’s death with respect to calculation of the deceased spouse’s unused exemption.
 - Portability will be of little utility unless the new law becomes permanent, and even then there are significant limitations. Trust planning will still be required to address state estate taxes. In Massachusetts and New York, for example, the estate tax exemption remains \$1,000,000 with a rate of 6 to 16%. In addition, trust planning will also be required to preserve the GST exemption of the first spouse to die.

Uncertainty in 2013 and Later

Although the new law introduces welcome additional latitude and flexibility in the federal transfer tax rules, those benefits may be short-lived. The 2010 legislation includes the same sunset provision as the 2001 legislation, with an expiration date of December 31, 2012. Consequently, unless Congress acts to make these rules permanent, we will return to the 2001 rules when the calendar turns to 2013. We are hopeful that this will not happen, but the future is impossible to predict.

Planning Opportunities

The new law offers tremendous estate planning opportunities.

- For the balance of 2010, taxable gifts may be made directly to grandchildren or trusts for their benefit for just a 35% gift tax (above \$1,000,000) without using any GST exemption. Of course, by making such a gift in 2010 one must forego the increased gift tax exemption that would be available if the gift were postponed until 2011.
- Taxable gifts in 2011 and 2012 will have the benefit of the increased exemption even if Congress does not extend the new law past 2012.

- An individual may now give away up to \$5,000,000 during lifetime free of gift tax (a married couple may give away twice that amount).
 - Such a gift may be made in trust, and with an allocation of GST exemption that trust should be able to grow free of future transfer taxes for another generation or longer.
 - 2011 and 2012 will be a good time to consider giving away illiquid assets, establishing a qualified personal residence trust for valuable real estate, forgiving family indebtedness, unwinding a split dollar life insurance program, and other transfers that have in the past seemed too expensive from a gift tax perspective.
- For residents of states like Massachusetts and New York that have an independent estate tax, property transferred by a lifetime gift will avoid that tax entirely.
- One trade-off for making a lifetime gift with appreciated property is that the opportunity for a basis step-up at death is lost; the donee takes the property with the donor's cost basis for income tax purposes.

We would be happy to talk with you about the impact the new law may have on your situation and the opportunities it may present for you. Please contact your advisor at Ropes & Gray with any questions.